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Water Company, Inc.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO. W-02113A-04-0616 **NOTICE OF FILING SUMMARY OF WITNESS' PRE-FILED TESTIMONY**

Chaparral City Water Company, an Arizona corporation ("Chaparral City" or 'Company"), hereby files the summaries of the pre-filed testimony of the following witnesses:

1. Robert N. Hanford
2. Ronald L. Kozoman
3. Thomas M. Zepp
4. Thomas J. Bourassa

The pre-filed direct, rebuttal and rejoinder testimonies of each of these witnesses supports Chaparral City's application for adjustments to its rates and charges for water utility service provided by the Company.

During the test year used in this proceeding, the 12 month period ending December 31, 2003, Chaparral City served approximately 12,000 water utility customers. Chaparral City's present rates and charges for utility service were approved by the Commission in Decision No. 57395 (May 23, 1991) and became effective on June 1, 1991. Revenues from Chaparral City's utility operations are presently inadequate to

provide Chaparral City a reasonable rate of return and the Company is requesting rate adjustments that will produce a revenue increase of approximately $1,773,091, an increase of 28.59% for a total revenue requirement of $7,975,935.

DATED this 26th day of May, 2005.

FENNEMORE CRAIG

By _____
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ORIGINAL and 13 copies of the foregoing
delivered for filing this 26th day of May , 2005, to:

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COPY hand-delivered this 26th day of May, 2005 to:

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ROBERT N. HANFORD

CHAPARRAL CITY WATER COMPANY

Docket No. W-02113A-04-0616

Summary of Testimony of Robert N. Hanford

Mr. Hanford is employed by Chaparral City Water Company ("Chaparral City" or the "Company") as District Manager. Mr. Hanford received a Bachelor of Science degree in Civil Engineering from the University of Nevada – Reno in 1978, and an MBA degree with an emphasis in management from Santa Clara University in 1985. He is registered as a professional civil engineer in California and Nevada, and has a current D3 water operator certification from the Arizona Department of Environmental Quality. Mr. Hanford is generally responsible for managing Chaparral City's day-to-day operations, including capital budget planning, water system operations and maintenance, customer service and community relations, and compliance with local, state and federal requirements pertaining to water quality and water supply.

Mr. Hanford prepared direct, rebuttal and rejoinder testimony in support of the Company's application for rate increases. Mr. Hanford's pre-filed testimony generally focuses on plant, operational and water supply issues. Mr. Hanford also addresses changes in Chaparral City's operations since it was acquired by American States in October 2000 and the impact such operational changes have had on the Company's operating expenses. Mr. Hanford's pre-filed testimony also briefly addresses the Company's need for purchased water and power adjustment mechanisms and rate design. In addition, Mr. Hanford's pre-filed testimony describes the Company's efforts to educate its customers concerning the rate increases being sought in this proceeding. A detailed summary of four key issues addressed in Mr. Hanford's pre-filed direct, rebuttal and rejoinder testimony follows:

1. Overview of Chaparral City.

The Company's service area is located in the northeastern portion of the Phoenix metropolitan area, in the Town of Fountain Hills and a small portion of the City of Scottsdale. This area is within the Phoenix Active Management Area and the Company is subject to certain water conservation requirements imposed to reduce groundwater pumping. During the test year, Chaparral City served approximately 12,000 customers. The majority of the Company's customers are residential, and the remainder are a mix of commercial, industrial and irrigation customers, including several golf courses. The Company's current rates were approved in Decision No. 57395 (May 23, 1991) and became effective on June 1, 1991. It will be more than 14 years between rate increases.

The Company's primary water supply, roughly 90%, is imported Colorado River water, which is delivered by means of the Central Arizona Project ("CAP"). Chaparral City has a contract for the delivery of CAP water and, at present, takes delivery of and uses almost the full 6,978 acre-feet it has been allocated. The CAP water is pumped from the main CAP aqueduct at

a raw water intake pumping station in Scottsdale, which is located approximately five miles east of Chaparral City's Shea Water Treatment Plant ("Shea WTP"). The Company also uses groundwater to augment its CAP water deliveries.

Chaparral City's sole shareholder is American States Water Company, which is publicly traded on the New York Stock Exchange. American States' primary operating subsidiary is Southern California Water Company. In October 2000, American States acquired the Company's stock from MCO Properties, Inc., a real estate development company located in Fountain Hills. This transaction was reviewed and approved by the Arizona Corporation Commission (the "Commission"). *See* Decision No. 62909, September 18, 2000.

2. Post Test year Plant.

There were two major capital projects completed after December 31, 2003 that the Company seeks to include in rate base. The first capital project involved the expansion of the Company's CAP water treatment facilities to add two additional 5-mgd Tricon modules. Construction of this project, referred throughout the pre-filed testimony as the Shea WTP, began in 2003 and all contract payments were made during the test year. It was originally scheduled to be completed in late 2003. Construction was delayed, however, and the new treatment modules were placed in service in March 2004. The total cost of the project is over $2 million.

The second project involves the construction of a major "backbone" water transmission main known as the Fountain Hills Boulevard Main Extension. This project involves the construction of approximately 10,000 lineal feet of 16" diameter ductile iron pipe from the vicinity of the Shea WTP to the vicinity of well #10. The need for the pipeline was identified during the Company's capital budget development process in the summer of 2003, and was completed in October 2004.

All of the post test year plant benefits ratepayers. The Company's customer base grew by over 65% between 1995 and 2001, and the prior owner had not taken steps to keep up with customer growth. The Shea WTP allows the Company to meet the demand for CAP water. It also provides redundancy of service. With this new treatment capacity, the Company can take a treatment module off line and still meet peak day demand measured by test year customer levels. This facilitates maintenance and repair and helps protect the Company and customers from catastrophic events like the recent water crises event in January of this year, where 1.4 million Phoenix residents faced emergency water quality issues. The Shea WTP also represents sound engineering, design and construction. The existing treatment facility built in the mid-1980s, is nearing the end of its useful life, and the Shea WTP is a step in the process of replacement in stages to meet customer needs.

Initially, the Main was constructed in connection with a new development, and for that reason a portion of the cost was paid by a developer. However, the remainder, the portion of the cost the Company seeks to include in rate base, was to oversize and upgrade the facility to allow the Company to loop its system to enhance both operational flexibility and increase system efficiency. The Main also allows Chaparral City to blend CAP water with groundwater and provides a means to address any arsenic issues.

The Company's request for inclusion of the Shea WTP and the Main is entirely consistent with recent Commissions decision. Nevertheless, Staff opposed inclusion of the Shea WTP in rate base and RUCO seeks to exclude the Main.

Staff reasons that the Shea WTP is not revenue neutral and that the existing facility should be retired before the new treatment capacity is included in rate base. Staff is incorrect. First, the ability to further expand the Shea WTP to meet future demand is simply sound engineering and good utility practice, and incidental to the question of whether the facility is revenue neutral. The Shea WTP is necessary for the Company to meet the demand for water service even if no customers are added after the test year. The facility was planned, designed, purchased and virtually complete before the end of the test year. The Shea WTP commenced operation in March 2004, less than 3 months after the test year and roughly six months before the rate case was filed. Second, the Company has no plans to retire the existing treatment capacity. To do so would eliminate much of the flexibility and redundancy sought to benefit ratepayers. Under these circumstances, the Shea WTP should be included in rate base.

RUCO's argues that the Main should be excluded from rate base based on the so-called matching principle, an argument that has repeatedly been rejected by the Commission. Here, RUCO's argument is further flawed. RUCO surmises that if the Main was built to increase efficiency and flexibility in service, there must be cost savings and those cost savings must be matched to the plant. However, there is no evidence that the Main was intended to result in cost savings or evidence that it has. The cost savings RUCO seeks to match to plant do not exist and provide no basis to exclude the Main from rate base.

3. Staff's Adjustments to Operating Expenses.

Staff adjusts a number of test year operating expense levels by using a three year average of the test year and the two prior years (2002 and 2001). Staff reasons that in several cases (e.g., transportation and miscellaneous expense), the test year expense levels are extraordinarily high. Besides being improper ratemaking, Staff's adjustment is not supported by the evidence in the record. In fact, the evidence shows that 2001 and 2002 are the irregular years, which means Staff's recommended adjustment will lead to expense levels well below the levels that will be incurred by Chaparral City while the rates approved in this proceeding are in effect.

This is true because American States acquired an under funded and poorly run utility in late 2000. Operational changes and improvements to improve all aspects of customer service began immediately thereafter, but it was not until 2003, the chosen test year, that the full impact of these operational changes were seen in operating expense levels. Therefore, Staff's use of three year averages lowers and distorts the Company's operating expenses to a level that will be well below the expenses incurred on a going-forward basis.

4. Customer Education.

Chaparral City has undertaken a significant effort to engage with members of the Fountain Hills community regarding this rate proceeding. The Company felt is was important from the outset to educate key community leaders, such as the Mayor and Town council, as well

as local business leaders, as to why the rate increase is necessary and reasonable. Educating customers is even more important.

As required by the Commission, notice to every customer was mailed and published by the end of January 2005 notifying them of the rate application and rate case hearing. In the mailing, the Company included a letter explaining the reasons for the proposed increase. Chaparral City next mailed a black and white brochure as a follow up to the original mail piece – again, at its own cost and above and beyond the legal requirements set forth by the Commission – to further outline and detail the amount of the increase and how the typical customer would be impacted. Chaparral City also sponsored a booth at the Fountain Hills Great Fair on February 25-27 of this year, where representatives from Chaparral City were on hand to answer questions from customers. and the Company also hosted two open houses for the public on February 17 and March 10 at the Fountain Hills Community Center. At the open houses, the Company had four manned stations with static displays explaining the rate increase and their place in the community. Residents were once again given the opportunity to ask questions and seek information about the rate filing.

Lastly, Chaparral City created a website, www.fhwaterfuture.com, so that individuals would be able to visit regularly and learn more about the reasons for the pending rate case. The Company's interactive website provides visitors the opportunity to request more information. As District Manager, Mr. Hanford receives and responds to e-mail inquiries from customers.

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RONALD L. KOZOMAN

CHAPARRAL CITY WATER COMPANY

Docket No. W-02113A-04-0616

Summary of Testimony of Ronald L. Kozoman

Mr. Kozoman is a Certified Public Accountant who specializes in public utility accounting and regulatory matters. He is testifying on behalf of Chaparral City Water Company on the issue of rate design.

Mr. Kozoman was employed by the Illinois Commerce Commission from 1977 to 1981 in various accounting and management positions, and testified in rate proceedings involving major Illinois utility companies. After moving to Arizona in 1981, Mr. Kozoman initially worked as a consultant, and then became an employee of the Arizona Corporation Commission ("ACC") and held the position of Chief Rate Analyst. While employed by the ACC, Mr. Kozoman testified on cost of capital and other issues in rate cases and other regulatory proceedings. After leaving the agency's employ, Mr. Kozoman worked as an independent consultant on behalf of utility companies, utility consumers and regulatory agencies. He has testified on numerous occasions before the ACC on rate design and cost of service issues, as well rate of return and regulatory accounting issues. Mr. Kozoman has also served as an instructor for the National Association of Regulatory Utility Commissioners at its Annual Regulatory Studies Program.

In this case, Mr. Kozoman developed Chaparral City's proposed rate design and prepared a cost of service study (G Schedules) to support that rate design. In his direct testimony, Mr. Kozoman proposed a design with two inverted commodity rate tiers. In his rebuttal testimony, Mr. Kozoman explained that Chaparral City would accept the key elements of the rate design proposed by the ACC Utilities Division ("Staff"). In summary, Chaparral City and Staff are in agreement on the following:

(1) Three inverted commodity rate tiers would apply to all residential customers on 3/4-inch meters; all other customers would have two inverted commodity rate tiers.

(2) The break-over point should increase by customer class (i.e., by meter size) in order to reduce extreme shifts in revenue responsibility from customers on smaller meters to customers on larger meters. Chaparral City has accepted the break-over points recommended by Staff for each size meter.

(3) The additional charge to recover costs for pumping water to higher elevations (pressure zones 2 and 3) within Chaparral City's service territory should be eliminated.

(4) The current monthly minimum service charge includes 1,000 gallons of water. Chaparral City agrees with Staff that this "free" water should be eliminated in order to send the correct price signal.

(5) A single, uniform volume rate would continue to apply to Chaparral City's irrigation customers.

Mr. Kozoman explained that although Chaparral City would adopt Staff's rate design recommendations, the commodity rates proposed by Staff are poorly designed, particularly in regard to the commodity rates proposed by Staff for residential customers on 3/4-inch meters. Staff has proposed to *reduce* the commodity rate applicable to the first 3,000 gallons of water by 22% for customers in pressure zone 1, by 27% for customers in pressure zone 2, and by 33% for customers in pressure zone 3. Mr. Kozoman explained that this discounted commodity rate is analogous to a "lifeline" rate under which water is sold at a substantial discount to customers who are unable to afford even a basic level of service. Staff's large discount creates a subsidy that must be paid for by other Chaparral City customers.

In addition, Mr. Kozoman explained that the large spread between Staff's proposed commodity rates create a substantial risk of under-collection of revenue. Staff's proposed commodity rate of only $1.68 for the first 3,000 gallons of usage by residential customers on 3/4-inch meters, combined with Staff's proposed commodity rate of $3.00 for all usage over 7,000 gallons, is a high-risk rate design. Mr. Kozoman prepared a cost of service study based on Staff's recommendations, which shows residential customers on 3/4-inch meters must use over 14,000 gallons per month before Chaparral City begins recovering its cost of service. Moreover, Chaparral City does not break even (i.e., recover all of its operating expenses) until usage exceeds 7,000 gallons per month.

Mr. Kozoman stated that Chaparral City has no experience with inverted tier rates, and it is uncertain how customers will react to them. Moreover, neither Staff nor any other party has proposed an adjustment to Chaparral City's test year revenue to account for the impact of reduced water usage. Mr. Kozoman concluded that Staff's rate design is not reasonable or appropriate under the circumstances, and recommended that the commodity rates be moved closer together. This will provide an appropriate price signal to customers because the commodity rates will increase with greater water usage, while reducing the degree of revenue erosion and instability that results from an inverted-tier rate design.

In his rebuttal and rejoinder testimony, Mr. Kozoman also addressed the rate design proposed by the Residential Utility Consumer Office ("RUCO"), and explained why that rate design is inappropriate. RUCO has also proposed an inverted-tier rate design with three commodity rate tiers. In contrast to Staff and Chaparral City, however, RUCO also proposed the use of the *same* break-over points between its commodity tiers, 8,000 gallons and 73,000 gallons. Those break-over points would apply to *all* customers, regardless of meter size and other water use characteristics. Mr. Kozoman explained in his testimony that under this rate design, virtually none of the monthly water usage by customers on smaller-sized meters will fall into the upper commodity tier, which applies only to usage over 73,000 gallons. As shown on Schedule 20, which is attached to the surrebuttal testimony of RUCO witness Rodney Moore, the average and median usage by residential customers on 3/4-inch meters are 7,656 gallons and 4,362 gallons, respectively. The overall effect of this rate design is to create a large subsidy that must be paid for by customers on larger sized meters. Thus, RUCO's rate design is simply a way to shift revenue responsibility from residential customers to commercial and industrial customers, rather than fairly allocating the recovery of revenues among customer classes.

THOMAS M. ZEPP

CHAPARRAL CITY WATER COMPANY

Docket No. W-02113A-04-0616

Summary of Testimony of Dr. Thomas M. Zepp

Dr. Zepp testifies on the appropriate cost of equity for Chaparral City Water Company. He is an economist and Vice President of Utility Resources, Inc., a consulting firm established in 1985. Dr. Zepp received his Ph.D. in Economics at the University of Florida, where he also taught economics and business courses at the graduate and undergraduate level. Before establishing Utility Resources, Dr. Zepp was a consultant at Zinder Companies from 1982 until 1985, and was a senior economist on the staff of the Oregon Public Utility Commissioner from 1976 to 1982. Dr. Zepp has testified before two Canadian regulatory bodies, 4 federal agencies and in 22 states on cost of equity, values of utility properties, economic costs of utility services, appropriate rate designs and other economic issues.

In this case, Dr. Zepp prepared direct, rebuttal and rejoinder testimony on behalf of Chaparral City. His estimates of the cost of equity were based on the discounted cash flow ("DCF") models used by the Federal Energy Regulatory Commission ("FERC") and the Risk Premium method used by the Staff of the California Public Utility Commission ("PUC"). Dr. Zepp also presented evidence on the current cost of equity derived from Arizona Corporation Commission ("ACC") decisions prior to 2001; currently authorized and earned returns on equity ("ROEs") for water utilities; and *Value Line Investment Service* projections of ROEs publicly traded water utilities will earn in the future. Even though Dr. Zepp believes the methods used by FERC and the California PUC Staff produce conservative estimates of the cost of equity, he presented cost of equity estimates based on those approaches to demonstrate the methods used by the ACC Staff and the Residential Utility Consumer Office ("RUCO"), an intervenor in this case, substantially understate a fair rate of return on equity for water utilities. Dr. Zepp noted these equity cost estimates are generally consistent with authorized and realized equity returns of the

water utilities in the sample group, and are below the equity returns projected by *Value Line* for 2006 and later periods.

In his rebuttal and rejoinder testimonies, Dr. Zepp identified and discussed a number of significant deficiencies in the methods used by the ACC Staff and RUCO cost of capital witnesses, which result in a downward bias, reducing the cost of equity produced by their models. Dr. Zepp also restated the ACC Staff and RUCO equity cost estimates with conceptually correct inputs in the models they chose to use. The table attached to this summary contains the most recent update of Dr. Zepp's cost of equity estimates as well as a list of equity cost estimates made by using the approaches taken by the ACC Staff and RUCO. The restatements of the ACC Staff and RUCO equity cost estimates generally produce estimates of the benchmark cost of equity that are within or close to the 10.4% to 10.9% ROE range found with the DCF models used by the FERC and the Risk Premium approaches used by the California PUC.

In his testimony, Dr. Zepp also explained why Chaparral City is more risky than the publicly traded water utilities used as proxies by the ACC Staff and RUCO witnesses to determine their benchmark equity costs. Dr. Zepp identified several unique risks that would cause investors to require a higher return, including Chaparral City's small size, the inverted-tier rate design proposed in the case, and the use of an historic test year with limited adjustments for out-of-period changes. Dr. Zepp concluded that if the purchased water and purchased power adjustment mechanisms requested by Chaparral City are approved, the required risk premium is 50 basis points. If those adjusters are not approved, however, the required risk premium is 110 basis points. Assuming the ACC approves the requested purchased water and purchased power adjustment mechanisms, Chaparral City's cost of equity falls in a range of 10.9% to 11.4%. Thus, Dr. Zepp concludes the 10.4% return on equity requested by Chaparral City is conservative and should be authorized.

Chaparral City Water Company

Rejoiner Table 9

Summary of Rejoinder Equity Cost Estimates for Water Utilities Sample and Chaparral City Water Company

	Water Utilites Sample	Indicated Cost of Equity for Chaparral City-[n/]
Updates of Zepp Equity Cost Estimates		
FERC 1-Step	10.9%	11.4%
FERC 2-Step	10.4%	10.9%
California RP Anaysis	10.6%	11.1%
Equity Costs Determined in Rebuttal Testimony		
Average of Currently Authorized ROEs	10.4%	10.9%
Average of ROEs Earned in 2004	10.0%	10.5%
Equity Cost based on Average Risk Premium Determined by ACC Prior to 2001		
• Based on Forecasted Rates	10.7%	11.2%
• Based on Rates in March 2005	10.1%	10.6%
FERC 1-Step w/ Mr. Ramirez's data	10.9%	11.4%
FERC 2-Step w/ Mr. Ramirez's data	10.5%	11.0%
Average of Mr. Ramirez's Equity Cost Estimates Restated in Rebuttal Table 12	10.4%	10.9%
Average of Mr. Ramirez's Equity Cost Estimates but with Methods used by the CPUC Staff	10.5%	11.0%
Restatement of Mr. Rigsby's Equity Cost Estimates		
• DCF	10.7%	11.2%
• CAPM	11.0%	11.5%
Equity Costs Determined in Rejoinder Testimony		
Response to Mr. Ramirez		
• Constant Growth DCF with Mr. Ramirez's Projections of DPS, EPS and Intrinsic Growth	10.8%	11.3%
• Mr. Ramirez's Multi-stage growth with Intrinsic growth included in his analysis for 2007-2009 and corrected terminal growth rate	10.1%	10.6%
• Updated CAPM with the same measure of Rf used to determine Rp and Rf	10.5%	11.0%
Response to Mr. Rigsby		
• Mr. Rigsby's DCF analysis but using analysts' forecasts of growth instead of br+sv growth	10.6%	11.1%
• Mr. Rigsby's CAPM based on current long-term Treasury rate of 4.64%	10.3%	10.8%
• Average ROE Projected for Mr. Rigsby's Water Utilities Sample by Value Line for 2008-2010	12.0%	12.5%

Note:

_n/ Equity cost estimates for Chaparral City assume proposed adjusters are authorized. If proposed adjusters are not approved, the cost of equity is 60 basis points higher.

5/11/2005

THOMAS J. BOURASSA

CHAPARRAL CITY WATER COMPANY

Docket No. W-02113A-04-0616

Summary of Testimony of Thomas J. Bourassa

Mr. Bourassa is a Certified Public Accountant who provides various accounting and consulting services to businesses, including utilities. He has prepared or has assisted in the preparation of rate applications for a number of Arizona water and wastewater utilities. In this rate proceeding, Mr. Bourassa was responsible for preparing, and is sponsoring, Schedules A through F of the standard filing requirements for Class A water utilities, as set forth in A.A.C. R14-2-103, and for the overall development of the revenue requirement for Chaparral City Water Company ("Chaparral City" or "Company") in this case.

Mr. Bourassa filed direct, rebuttal and rejoinder testimony, which generally addresses the following aspects of Chaparral City's rate application:

(1) Revenue Requirement.
(2) Rate Base (original cost, reconstruction cost and fair value).
(3) Revenues and Expenses (including depreciation and taxes).
(4) Purchased Power and Purchased Water Adjustment Mechanisms.

A summary of the key issues addressed in Mr. Bourassa's pre-filed testimony follows:

I. REVENUE REQUIREMENT

The parties' respective revenue requirements as of the rejoinder stage of this proceeding are as follows:

	Revenue Req.	Revenue Incr.	% Increase
Staff - Surrebuttal	$7,012,536	$ 809,692	13.05%
RUCO – Surrebuttal	$6,803,753	$ 603,988	9.74%
Company Rejoinder	$7,975,935	$ 1,772,091	28.59%

As Mr. Bourassa explained throughout his pre-filed testimony, the Company's recommend rate of return should be applied to the fair value rate base ("FVRB") to determine the revenue requirement.

A substantial difference between the Company's proposed revenue requirement and that of either Staff or RUCO arises due to Staff and RUCO's applying their recommended rates of rates of return to the original cost rate base ("OCRB"). Once determined by applying the rate of return to OCRB, the Staff and RUCO revenue requirements remain the same for FVRB, meaning that the return on fair value recommended by both Staff and RUCO are "backed into". Under this methodology, the FVRB is meaningless and has no impact or influence on rates.

Staff's argument that applying the recommended rate of return to the FVRB results in a windfall was rebutted by Mr. Bourassa in his rebuttal and rejoinder testimonies. As Mr. Bourassa explains, the methodology proposed by the Company ensures that the utility earns a return on the current value of the property devoted to public service. The fair value approach mimics the competitive marketplace, in which the value of investments increase or decrease and investors are entitled to receive the benefit of their investment if the value of the property increases above its original cost. Conversely, if the value of the property declines below its original cost, investors must accept the adverse consequences. Neither case is "unfair" to anyone, nor does it produce a "windfall" to anyone.

Mr. Bourassa also rebuts RUCO's argument that using FVRB to determine the revenue requirement double counts inflation. Most utilities have a capital structure composed of common equity and long-term debt. Because the long-term debt component has a fixed cost there cannot be any inflationary component associated with the cost of debt. As for the equity component, the value of property may go up or down due to an unknown number of factors. Inflation may or may not be relevant to the determination of an asset's value, but the Commission is charged with the duty to provide the utility a return on the current value of the asset. The impact inflation has had on the current value is always irrelevant.

II. RATE BASE

A. Development of Rate Base

Mr. Bourassa testified to the development of the Company's Original Cost Rate Base ("OCRB") and Reconstruction Cost Rate Base ("RCRB"). Several adjustments were made to the OCRB, including an adjustment to include post test year plant consisting of the Shea Water Treatment Plant ("Shea WTP") and the Fountain Hills Boulevard Main ("Main") and additional accumulated depreciation on plant in service based on the computed amount since the Company's last rate case. RCRB was based on the Company's trended RCN plant-in-service study using national Handy-Whitman indexes to determine the trended plant values. The Company recommended that a 50/50 weighting of Chaparral City's OCRB and RCRB be used as the FVRB as a means of eliminating issues between the parties, even though a 50/50 weighting of OCRB and RCRB is a relatively conservative measure of current value. No party opposed the 50-50 weighting of OCRB and RCRB to reach FVRB.

The Company accepted Staff's adjustments to OCRB, including an increase to plant in service to meter and pumping equipment for capitalized expenses, adjustment to accumulated depreciation for historical plant retirements, and a "luxury" automobile adjustment to plant in service and accumulated depreciation. The Company also accepted RUCO's proposed adjustments to OCRB, which included an increase to additional accumulated depreciation (using half-year convention) on post test year plant and a decrease to accumulated depreciation related to historical plant retirements. Finally, the Company proposed additional adjustments to OCRB, including increasing deferred regulatory assets for the cost of tank inspection and cleaning, and an increase to plant in service for temporary office space costs incurred in the construction of the Shea WTP.

B. Post Test year Plant

As Mr. Bourassa explains in his pre-filed testimony, the Commission has authorized post test year plant in rate base when the plant is revenue neutral (i.e., providing service to customers at end of test year) and completed and placed in service a reasonable time before the hearing so that it can be inspected and audited. *See, e.g., Rio Rico Utilities, Inc.*, Decision No. 67279 (October 5, 2004); *Arizona Water Company—Eastern Group*, Decision No. 66489 March 19, 2004); *Bella Vista Water Company*, Decision No. 65350 (Nov. 1, 2002); *Arizona Water Company—Northern Group*, Decision No. 64282 December 28, 2001); *Paradise Valley Water Company*, Decision No. 61831 (July 20, 1999); *Far West Water Company*, Decision No. 60437 (September 29, 1997). The Company's request that the Shea WTP and Main be included in rate base meets each of these criterion. Nevertheless, Staff recommends exclusion of the Shea WTP from rate base, but agrees with the Company that the Main should be included. RUCO recommends that the Shea WTP be included in rate base but would exclude the Main.

Staff argues that post test year plant should only be included in rate base under extraordinary circumstances. The Commission has previously held that extraordinary circumstances are not required. Decision No. 67279, Decision No. 65350. Mr. Bourassa also addressed each of the criteria employed by Staff for determining whether extraordinary circumstances exist. The cost of the Shea WTP is significant and substantial, and excluding it from rate base would have a serious and detrimental impact on the Company's financial health. The Shea WTP is prudent and necessary for the provision of service to test year customer levels and as such is revenue neutral post test year plant. Mr. Bourassa also explains that the existing capacity does not need to be retired before the Shea WTP is included in rate base as long as the existing capacity is still being used by the Company.

Mr. Bourassa also addressed the arguments set forth by RUCO to exclude the Main from rate base. RUCO's recommendation rests on the claim that the Main was only an enhancement for water provisioning and the "cost savings" from the Main could not be quantified, leading to a mismatch. Notably, RUCO makes no effort to adjust for increased costs associated with the Shea WTP even though it agrees that plant should be in rate base. In any event, the Commission has rejected RUCO's so-called "matching principle" argument on several occasions as the cases cited above illustrate. Moreover, the mismatch identified by RUCO relies on unaccounted for "cost savings" associated with the Main, cost savings that the Company has not claimed and that RUCO has not established.

C. Miscellaneous Rate Base Issues in Dispute

Both Staff and RUCO declined to adopt the Company's proposed adjustment to deferred regulatory assets for tank inspection and cleaning. As Mr. Bourassa testified, the Company has committed capital for a prudent and necessary cost to the benefit of ratepayers and the costs should be afforded rate base treatment. Staff is incorrect that these costs were accounted for in Staff's normalization using three year averages, as Staff claims. RUCO is also incorrect that the Company had recovered these costs in its 2003 revenues. The costs of tank cleaning and maintenance should be allowed because these costs were never included as part of the revenue requirement in the Company's last rate case.

Finally, the Company has proposed to eliminate the collection of hook-up fees as revenue and treat them as CIAC on a going-forward basis. All parties agree to this treatment. In response, RUCO reduced rate base by increasing CIAC to match the hook-up fees collected as revenues during the test year. RUCO's position is equivalent to recalculating and restating accumulated depreciation by using proposed new depreciation rates. When new depreciation rate are proposed, accumulated depreciation is not re-stated, as that would constitute retroactive ratemaking. RUCO's position on reclassifying test year hook up fees is similarly improper and would result in confiscation of Chaparral City's used and useful property.

III. REVENUES AND EXPENSES

A. Overview of Income Statement

In his direct testimony, Mr. Bourassa described the Company's proposed adjustments to the test year in order to normalize revenues and expenses and to take into account known and measurable changes. Some of the more notable adjustments include:

(1) Increasing property and income taxes to reflect proposed revenues;
(2) Inclusion of rate case expense amortized over 4 years;
(3) Increasing purchased water expense due to higher CAP and CAGRD rates;
(4) Increasing purchased power to reflect the 2004 rate increase from SRP;
(5) Removal of hook-up fees from revenues to reflect the Company's proposal to treat future hook-up fees as CIAC;
(6) Increasing salaries and wages due to wage increases that occurred in 2004.

The Company also proposed eliminating the existing composite depreciation rate and the adoption of specific depreciation rates by assets class based on the "typical and customary" rates developed by Staff.

A number of additional adjustments were made at the rebuttal and rejoinder stages based on the positions of the other parties. Notable adjustments include:

(1) Increasing annualized depreciation reflecting the increased cost of the Main, capitalized meter and pumping equipment expenses, as well as capitalized temporary office space expenses;
(2) Increasing salaries and wages to include overtime and reflect 2004 capitalization rates;
(3) Removal of tank inspection and cleaning costs from outside services expense and increase outside service expense to reflect the annual amortization of these costs using an amortization period of 5 years;
(4) Removal of capitalized expenses from repairs and maintenance for temporary office space related to the construction of the Shea WTP services;
(5) Removal of SRP late charges and employee relocation costs from miscellaneous expense;

(6) Removal of CAP monitoring costs from outside services expense;
(7) Decreasing water testing expense to Staff's recommended level;
(8) Increasing purchased power expense to reflect recent (2005) SRP and APS rate increases;
(9) Decreasing purchased water expense for reflect CAGRD credits; and
(10) Removal of employee barbeque costs from miscellaneous expense.

With these various adjustments based on known and measurable changes, the Company's proposed level of operating expenses is equal to $5,621,122 Staff and RUCO's recommended operating expenses are lower, and there remain a number of income statement issues in dispute between the parties.

B. Depreciation Rates

Staff believes the depreciation rates chosen by the Company, which rates were developed by Staff to be asset-specific, better reflect utility asset lives rather than the composite rate approved in the last rate case for Chaparral City. In contrast, RUCO proposed depreciation rates of its own based on average depreciation rates recently approved. RUCO's use of the rates approved for several other utilities, some of which have multiple systems, results in depreciation rates that are skewed. For example, RUCO use of averages results in the rates approved for Arizona Water Company, which has multiple systems, being more heavily weighted than others. In addition, RUCO has used at least one set of composite depreciation rates in its averaging. In the end, RUCO's proposed depreciation rates simply do not reflect the lives of the Company's utility assets.

C. Property Taxes

The Company and Staff agree on the method to be used to determine property taxes, which methodology accounts for proposed revenues as a component of the Arizona Department of Revenue property tax calculation. The difference between the Company and Staff on the recommended property tax expense level is due to the different revenue levels recommended. RUCO, in contrast, continues to offer the same historical revenue approach, using the test year and the two prior years. This approach has repeatedly been rejected by the Commission because it fails to account for increased revenues which will result in increased property tax expense during the period rates will be in effect. *Rio Rico Utilities*, Decision No. 67279 at 8; *Arizona Water Company*, Decision No. 64232 (December 28, 2001) at 12-13; *Bella Vista Water Company*, Decision No. 65350 at 15-16; *Far West Water Company*, Decision No. 62649 (June 13, 2000) at 8. In fact, all RUCO has done, as it did in the *Rio Rico* case, is correctly calculate the property taxes for the year after the test year using the ADOR formula.

D. Staff's Use of Three Year Averages

The Company disagrees with Staff's normalization of office supplies expense, outside services expense, transportation expense, and miscellaneous expense using a three-year historical average. In addition to the evidence that 2001 and 2002 are irregular, Mr. Bourassa explains that averaging does not constitute a known and measurable change justifying a change to the test

year. Instead, Staff's three-year averaged expense levels are mere speculation and bear little to no relationship to the expense levels the Company will occur on a going-forward basis.

E. Wages and Salaries

Mr. Bourassa acknowledged RUCO's criticisms that the wages and salaries adjustment in the Company's direct filing did not account for capitalized wages, but he also pointed out that he did not include overtime or an adjustment to payroll burden in the direct filing calculations. In rebuttal, the calculations included overtime wages and payroll burden, as well as the 2004 capitalization rates, which were materially similar to those used in 2003, the test year. This does not change the fact that the capitalization rates employed by RUCO were incorrect, which the Company identified to RUCO on a number of occasions. RUCO also failed to account for the annualized wages of two employees hired to replace two dismissed employees during the test year. Mr. Bourassa testified that while he used 2004 capitalization rates in the Company's rebuttal calculations, the 2004 capitalized wages were nearly identical to the 2003 capitalized wages.

F. Capitalized Expenses

The Company accepted Staff's recommendation to capitalize meter and pumping equipment expenses and agreed with RUCO to capitalize temporary office space costs related to the Shea WTP. The Company also agreed with RUCO that the tank cleaning and inspection costs were a non- recurring annual expense. However, unlike RUCO, the Company proposed recovery over 5 years – the level of time between inspections recommend by American Water Works Association standard AWWA D101-53 for tank inspection. Otherwise, the Company will be incurring this necessary and prudent expense every five years, but never given an opportunity for recovery.

G. Purchased Power and Water Expenses

The Company and Staff are in agreement on the level of purchased water expense. Both the Company and Staff used 2005 CAP and CAGRD fees in their calculations, while RUCO used 2004 rates and fees. Staff and the Company are also in agreement that an adjustment must be made to reflect rate increases for SRP and APS. RUCO disagrees arguing that such changes are to far out of the test year. Yet, in Arizona Water Company's pending Western Group rate case (Docket No. W-01445A-04-0650), RUCO witness Mr. Rigsby made an adjustment for the recent 2005 rate increases from APS. The test year for both cases is the same. Mr. Rigsby's adjustment in the Arizona Water case is correct and the same rationale applies here. The adjustments to increase purchased power expense are based on the test year costs, so only the power costs related to the test year were increased. The adjustment does not take into account the costs from additional gallons pumped for customer growth outside the test year. Therefore, the adjustment does match the test year revenues.

IV. PURCHASED WATER AND POWER ADJUSTMENT MECHANISMS

The Company has proposed adjuster mechanisms for purchased water and purchased power. The Company's proposal was designed to only recover increases due to increases in rates

that the Company is charged, and not for increases due to customer growth. This is necessary because purchased water and purchased power represent significant expense to the Company. It is also consistent with A.R.S. § 40-370, which currently authorizes water utilities to apply to the Commission for approval of surcharges to recover increase in specific, readily identifiable costs beyond the control of the utility, including purchased water and purchased power.

RUCO recommended that the purchased water and purchased power adjuster mechanisms not be approved because these expenses did not meet its criteria of narrowly defined expenses that constitute a significant portion of the utilities expenses over which a utility has no control. RUCO is incorrect, however, as these are significant costs and even small increases in the rates charged, which the Company cannot control, undermine Chaparral City's opportunity to earn its authorized rate of return. Staff opposed the purchased power adjuster mechanism on the basis that if approved it would create a disincentive to conserve. But there is no disincentive to conserve because, for example, the purchased power adjuster only captures increases in rates charged the Company, not increases from more demand. Staff opposed the purchased water adjuster mechanism because Staff did not believe the potential increases in expense were material. Mr. Bourassa rebutted this argument by showing the potential dollar impacts of increases in both purchased water and purchased power expenses. In sum, the recommendations of Staff and RUCO are inconsistent with state policy, unfair to the Company and should be rejected.

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